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Executive Office of Health  
and Human Services

Seena Perumal Carrington  
Acting Commissioner  
Division of Health Care  
Finance and Policy

# The Employer Free Rider Surcharge: Policy, Objectives, and Results

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DIVISION OF  
Health Care  
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## **Introduction**

In April 2006, Massachusetts enacted landmark health reform legislation with the goal of achieving near universal coverage. Since the law's passage, over 350,000 Massachusetts residents have gained health coverage through government programs and private coverage.<sup>1</sup> This report provides an overview of an innovative policy tool included in the law – the Free Rider Surcharge – that was intended to encourage enrollment in private coverage.

The Free Rider Surcharge, managed by the Division of Health Care Finance and Policy (DHCFP), promotes compliance by employers with their requirement to offer a Section 125 Plan. A Section 125 Plan permits workers to use pre-tax wages to make a contribution to their health insurance premiums or to pay the full cost of their health insurance premiums. Employers can satisfy this particular requirement whether or not they subsidize the coverage of their workers.

This report was developed to help interested parties understand the details of the Free Rider Surcharge policy and its objectives in the context of Massachusetts health reform. The report also presents the results of DHCFP's Free Rider Surcharge analysis from the program's initial two years: fiscal year 2008 and fiscal year 2009. Supplementary analysis on the prevalence of Section 125 Plans in Massachusetts is also included, as well as an explanation of how national health reform may affect Massachusetts health reform in this area.

## Background

The Massachusetts landmark 2006 health reform law (An Act Providing Access to Affordable, Quality, Accountable Health Care) Chapter 58 of the Acts of 2006: ushered in a series of new policies designed to promote access to health insurance in an effort to achieve near universal coverage of its residents. In 2010, DHCFP released the results of its annual household survey, conducted by the Urban Institute, which revealed that only 1.9% of the state's residents are uninsured.<sup>2</sup> In 2004, before health reform was passed, 7.4% of residents were uninsured.<sup>3</sup>

The lynchpins of Massachusetts' health reform law are: (1) the individual mandate, which requires adults in the state to be insured if affordable insurance is available to them; (2) the merging of the individual and small group insurance markets; (3) the expansion of MassHealth, Massachusetts' Medicaid program; (4) the creation of the Health Connector, which administers Commonwealth Care, a subsidized health insurance program for low-income residents, and functions as an insurance exchange for individuals and small businesses; and (5) a set of new responsibilities for employers. The new responsibilities for employers include the Fair Share Contribution, the Section 125 Plan requirement, the Free Rider Surcharge, and the Health Insurance Responsibility Disclosure (HIRD) requirement.

The Fair Share Contribution (FSC) requires all employers with 11 or more full-time equivalent employees (FTEs) to make a "fair and reasonable" contribution toward the health care costs of their workers.<sup>4</sup> Employers that do not make a "fair and reasonable" contribution may be assessed up to \$295 per FTE annually, and that revenue is used to finance the Commonwealth Care Trust Fund.

The remaining three employer requirements (the Free Rider Surcharge, the Section 125 Plan requirement, and the Health Insurance Responsibility Disclosure requirement) work in combination to promote the availability of Section 125 Plans. The Free Rider Surcharge was intended to encourage employers to adopt Section 125 Plans, which would make health insurance more affordable to workers, especially those who are not offered coverage by their employers. One of the purposes of the Health Insurance Responsibility Disclosure (HIRD) requirement is to monitor compliance with the Section 125 Plan requirement and to determine liability for the Free Rider Surcharge.

## **Policy & Objectives: Section 125 Plans, the Free Rider Surcharge, and HIRD**

### **Section 125 Plan Requirement**

Employers with 11 or more Full-Time Equivalents (FTEs) are required to establish and maintain a Section 125 Plan.<sup>5</sup> These employers must offer a Section 125 Plan to employees who work, on average, 64 hours or more per month. The Massachusetts Health Connector, the Commonwealth's health insurance exchange, promulgates the regulation for the Section 125 Plan requirement.

The adoption of Section 125 Plans by employers allows employees to pay their contributions towards health insurance using pre-tax income. Section 125 refers to §125 of the Internal Revenue Code, which allows health insurance expenditures to be tax deductible. Workers that are not offered insurance with an employer contribution are able to realize savings by purchasing individual health insurance plans using pre-tax income.

The Health Connector offers two programs—Business Express and the Voluntary Plan—for an employer to establish a Section 125 Plan.<sup>6</sup> Setting up a plan through either program is one way to comply with the Section 125 Plan requirement. Business Express allows employers with 50 or fewer workers to set up employer-sponsored plans where the employer contributes a portion of the health insurance premium and the employee pays the remainder.<sup>7</sup> The Voluntary Plan is for employers who do not offer an employer contribution toward a health insurance plan. This program, which is open to all employers, permits employees to use their own tax-free earnings to pay for a health plan that they choose among the health plans that are available on the Health Connector's website.

### **Free Rider Surcharge**

The Free Rider Surcharge is intended to promote compliance with the Section 125 Plan requirement.<sup>8</sup> Employers with 11 or more FTEs that do not maintain a Section 125 Plan in accordance with the requirement may be liable for a Free Rider Surcharge if their workers or their workers' dependents access medical care through the state's Health Safety Net (HSN). The HSN reimburses hospitals and community health centers for health care services provided to Massachusetts residents who are otherwise ineligible for health insurance programs.<sup>9</sup>

Prior to Massachusetts health reform, employers had no obligations related to their employees' use of the HSN. This arrangement contributed to the notion that these employers were "free riders" whose workers received medical care reimbursed by a surcharge on premiums paid by employers who did offer health coverage.

For employers that do not comply with the Section 125 requirement, the Free Rider Surcharge is determined based on the cost of HSN medical services incurred by workers or their dependents that exceeds \$50,000.<sup>10</sup>

The assessment percentage is determined based on the size of the employer and the amount of HSN-funded costs.<sup>11</sup>

### **Assessment Percentage by Employer Size and HSN Funded Costs**

<b>HSN Funded Costs</b>	<b>11-25 FTEs</b>	<b>26-50 FTEs</b>	<b>&gt;50 FTEs</b>
<b>\$50,000-\$75,000</b>	<b>20%</b>	<b>50%</b>	<b>80%</b>
<b>\$75,001-\$150,000</b>	<b>30%</b>	<b>60%</b>	<b>90%</b>
<b>Over \$150,000</b>	<b>40%</b>	<b>70%</b>	<b>100%</b>

The penalty percentage can be reduced based on the percentage of employees who participate in the company health plan as determined under the Fair Share Contribution regulation.

Employers are prohibited from discriminating against an employee based on his or her receipt of HSN funded care or for accurately reporting information about their place of work upon receipt of HSN funded care. Violation of this rule is considered a violation of the Massachusetts consumer protection statute.<sup>12</sup>

### **Employee and Employer Health Insurance Responsibility Disclosure**

The Health Insurance Responsibility Disclosure (HIRD) requirement monitors compliance with the Section 125 Plan requirement and helps determine if an employer is liable for the Free Rider Surcharge via the Employer HIRD and the Employee HIRD.<sup>13</sup> The HIRD regulation requires employers with 11 or more FTEs to file an online report (the Employer HIRD) with DHCPF to confirm whether they are offering a Section 125 Plan in compliance with the Connector's regulation. It also collects other types of data about health benefits.

The Employee HIRD is a form that employees must sign if they decline participation in the employer's Section 125 Plan or enrollment in a group health plan being offered by the employer. The forms must be retained by the employer for three years from the date they are signed. The forms serve as verification that the employer is offering participation in a Section 125 Plan in accordance with the Connector's regulation and protects the employer from any liability for the Free Rider Surcharge in the event that employees or their dependents receive care from the HSN. The Employee HIRD form also serves to inform employees who decline Section 125 participation and/or health insurance coverage about the Massachusetts individual responsibility to obtain health coverage.

## **Free Rider Surcharge Analysis**

### **Methodology**

DHCFP utilizes data from the Department of Revenue (DOR), the Division of Unemployment Assistance (DUA), the Virtual Gateway web portal,<sup>14</sup> Health Safety Net (HSN), and Health Insurance Responsibility Disclosure (HIRD) records to identify employers that are potentially liable for the Free Rider Surcharge. DHCFP matches HSN claims to DOR wage data to determine if users who reached the threshold cost were employed at the time that they received health care services. Potential liability is determined based on employer size and the aggregate HSN costs associated with that employer. DUA Fair Share Contribution data is used to determine if the assessment should be reduced based on the percentage of the employer's full-time workers enrolled in a group health plan.

In the case of dependents utilizing the HSN, DHCFP's analytic team constructs "family units" to use as the basis of its analysis. The family data is accessed from the Virtual Gateway to determine if an HSN user is a dependent of an employee. Any employer associated with the household has its potential liability pro-rated based on that employer's percentage of the household's gross wages. If there is only one employer associated with the household, the sole employer is potentially liable for the full assessment.

The data regarding employment and HSN costs are matched with Health Insurance Responsibility Disclosure (HIRD) data, which reveals whether an employer has a Section 125 Plan in place. If an employer has a Section 125 Plan in place in accordance with the Connector's regulation, it is exempt from any possible assessment.

### **Results**

For both fiscal years 2008 and 2009, DHCFP found that zero employers were liable for the Free Rider Surcharge. There were no employers that met the cost threshold for Free Rider Surcharge liability that did not comply with the Section 125 requirement.

The fact that not a single employer has been found liable for the Free Rider Surcharge provides strong evidence that the Free Rider Surcharge has been an effective tool in promoting the availability of Section 125 Plans among companies. The absence of any assessments under a relatively new and well-monitored requirement speaks to the commitment of Massachusetts employers in ensuring the success of health reform.

## **Supplementary Analysis: Section 125 Plans in Massachusetts**

The Free Rider analysis serves as one source of data that demonstrates the effectiveness of Massachusetts health reform policies to promote Section 125 Plans. This report presents three additional sources of data and analysis that all point to the widespread availability of Section 125 Plans in Massachusetts: Employer HIRD filings, Employer Survey results, and enrollment statistics for the Connector's Voluntary program.

### **Employer HIRD Data**

Employer HIRD data reveal a high level of compliance with the Section 125 Plan requirement. According to Fiscal Year 2010 HIRD records,<sup>15</sup> 95% of employers with 11 or more FTEs reported that they have adopted a Section 125 Plan in accordance with the Connector regulation. This represents an increase from Fiscal Year 2009 when 89% of employers with 11 or more FTEs reported that they had adopted a Section 125 Plan.

### **DHCFP Employer Survey**

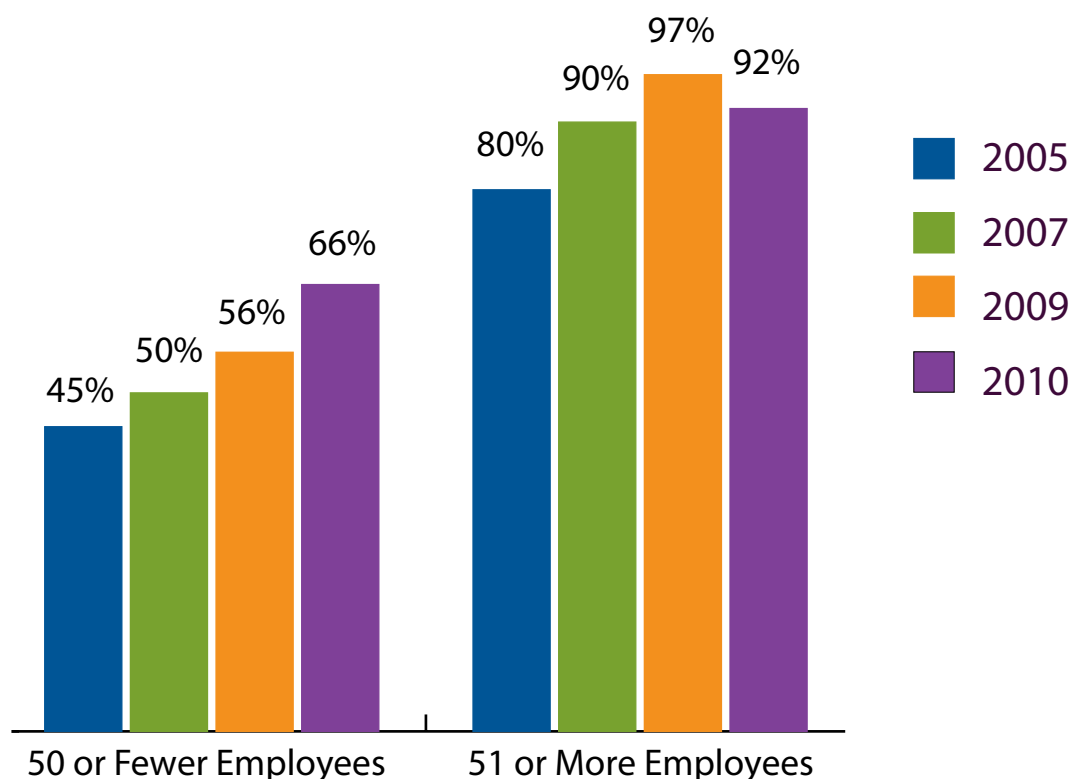
The Division of Health Care Finance and Policy's annual employer survey also points to the widespread availability of Section 125 Plans.<sup>16</sup> On the subject of Section 125 Plans, the Employer Survey is the only data included in this report that presents data from before and after Massachusetts health reform and, consequently, can offer a possible assessment of the success of Massachusetts policies to promote Section 125 Plans.

The percentage of firms with 50 or fewer employees (small firms) offering Section 125 Plans has been steadily increasing from 45% in 2005 (before health reform was passed) to 66% in 2010.<sup>17</sup> This represents an increase of over 46%.

For firms with 51 or more employees (large firms), only 80% of firms offered a Section 125 Plan in 2005, before health reform passed. In 2010, 92% of firms offered a Section 125 Plan. This represents a 15% increase in the number of large firms offering Section 125 Plans.



## Employers Offering Pre-Tax IRS Section 125 Plans by Firm Size (2005-2010)



Source: DHCFP Massachusetts Employer Survey, 2010.

Results from the DHCFP Employer Survey indicate that the implementation of Massachusetts health reform policies intended to promote the use of Section 125 Plans coincided with an increase in the percentage of employers offering Section 125 Plans.

There are a number of reasons why HIRD data and the DHCFP Employer Survey reveal different percentages of firms with Section 125 Plans. First, Employer HIRD filings are collected only from employers with 11 or more FTEs. By contrast, the Employer Survey includes smaller firms with as few as three employees. It is possible that these smaller employers do not offer Section 125 Plans because they are not subject to the Section 125 Plan requirement or the Free Rider Surcharge. Second, survey data differs from government filings because surveys utilize representative samples, and government filings attempt to collect data from all employers (a population sample) as a means of determining compliance with a regulation. It is also possible that the individuals from companies responding to a survey as opposed to submitting regulatory compliance information have varying levels of information and detail regarding their companies' benefit policies.

## **The Health Connector “Voluntary Plan”**

Setting up a Section 125 Plan through the Connector is one way that an employer can comply with the Section 125 Plan requirement. The Voluntary Plan is intended for employers who do not pay any portion of health insurance premiums for some or all of their employees. With the Voluntary Plan, employees can use their pre-tax dollars to choose one of the unsubsidized health plans offered by the Health Connector.

Since July 2007, 3,500 employers have set up a Section 125 Plan through the Voluntary Plan. Of these employers, 639 employers have at least one employee who has opted to purchase health insurance through the Voluntary Plan.<sup>18</sup>

As of January 2011, 1,995 employees and family members purchase health insurance through the Connector using the Voluntary Plan. Connector data indicate that the program is most popular among independent contractors, restaurants, and white-collar firms.<sup>19</sup>

## **Looking Ahead: Impact of Federal Health Reform**

The Patient Protection and Affordable Care Act (PPACA) was signed into law by President Barack Obama on March 23, 2010. This federal health reform law includes an individual mandate, expansions of existing public programs, subsidies to help low and middle-income people afford health insurance, tax changes to the financing of health care, the creation of health insurance exchanges and new responsibilities and opportunities for employers.

Massachusetts health reform served as a model for the overall structure of federal health reform. While many of the federal policies will be familiar to Massachusetts residents, some of the details differ between the two laws.

One area of difference is the role of Section 125 Plans as a tool to promote access to health insurance. The federal health reform law states that, starting in 2014, employees will not be able to buy individual health insurance policies through an exchange on a pre-tax basis using a Section 125 Plan.<sup>20</sup> This rule conflicts with one of the key goals of Massachusetts health reform, which is to promote the use of Section 125 Plans as a way of encouraging employees to obtain private coverage whether or not they have access to coverage with an employer contribution.<sup>21</sup>

Shortly after federal health reform passed, the Massachusetts Executive Office of Health and Human Services convened a federal health reform implementation work group chaired by Secretary JudyAnn Bigby, M.D. with representation across state government. This workgroup is developing a strategy to align employer policies, including the Free Rider Surcharge and Section 125 requirement, with federal health reform. For more information about the Commonwealth's progress implementing and planning for national health reform, including updates on issues that relate to the Free Rider Surcharge, please visit [www.mass.gov/nationalhealthreform](http://www.mass.gov/nationalhealthreform).

## Endnotes

- <sup>1</sup> *Key Indicators*, Division of Health Care Finance and Policy, February 2011.
- <sup>2</sup> *Health Insurance Coverage in Massachusetts: Results from the 2008-2010 Massachusetts Health Insurance Surveys*, Division of Health Care Finance and Policy, 2010. The survey is limited to the Massachusetts non-institutional population.
- <sup>3</sup> In 2008, DHCFP implemented a new survey methodology. Therefore, caution should be taken when comparing results to previous years.
- <sup>4</sup> The FSC regulation (114.5 CMR 16.00) defines an employer as making a “fair and reasonable contribution” as follows:
  - Employers with 11-50 FTEs: Employer offers at least 33% contribution towards a premium OR covers 25% of full-timers.
  - Employers with more than 50 FTEs: Employer offers at least 33% contribution towards a premium and covers 25% of full-timers; OR cover 75% of full-timers.
- <sup>5</sup> The regulation that governs the Section 125 Plan requirement is called the “Employer Sponsored Health Insurance Access” rule. It is 956 CMR 4.00 and is promulgated by the Connector under MGL c. 151F.
- <sup>6</sup> See the Connector’s web page for more information: [www.mahealthconnector.org](http://www.mahealthconnector.org)
- <sup>7</sup> Business Express requires an employer to contribute at least 50% of the premium.
- <sup>8</sup> The regulation that governs the “Free Ride Surcharge” is the Employer Surcharge for State Funded Health Costs.” It is 114.5 CMR 17.00 and is promulgated by the Division of Health Care Finance and Policy under MGL Ch. 118G §18B.
- <sup>9</sup> *Health Safety Net: 2009 Annual Report* Division of Health Care Finance and Policy, December 2009.
- <sup>10</sup> The Free Rider Surcharge is only applied if at least one of two additional conditions are met:
  1. At least one employee or a dependent of an employee has more than three HSN-funded admissions or visits during the year.
  2. A firm’s employees and/or their dependents have five or more HSN-funded admissions or visits during the year.
- <sup>11</sup> If an HSN-funded employee works for two companies, DHCFP assesses the two employers on a pro-rated basis. Similarly, if an HSN-funded dependent is the dependent of two employees, then DHCFP will assess the two employers on a pro-rated basis.
- <sup>12</sup> MGL Ch. 93A.
- <sup>13</sup> The Health Insurance Responsibility Disclosure (HIRD) regulation is 114.5 CMR 18.00. It is governed by the Division of Health Care Finance and Policy under MGL Ch. 118G § 6C. See the Division of Health Care Finance and Policy’s web page for more information at [www.mass.gov/dhcfp/hird](http://www.mass.gov/dhcfp/hird).
- <sup>14</sup> The Virtual Gateway processes and maintains eligibility information for MassHealth, Commonwealth Care, the Health Safety Net, and many other health and human service programs.
- <sup>15</sup> For HIRD filings, all data are self-reported by employers. A small number of outlier filings based on unrealistic reported payroll hours and/or number of full-time employees were removed from the population subset for the purpose of the analysis.
- <sup>16</sup> *Results from the Massachusetts Employer Surveys: Updated for 2010*, Division of Health Care Finance and Policy, December 2010, P. 35.
- <sup>17</sup> Since 2009, the Employer Survey defined small employers as having three to 50 employees; in prior years, it was two to 50 employees.
- <sup>18</sup> Connector Voluntary Plan data, January 2011.
- <sup>19</sup> Ibid.
- <sup>20</sup> *State Guide to Federal Health Reform for Massachusetts Employers*, Executive Office of Health and Human Services, October 2010, p. 26.
- <sup>21</sup> The new federal rule does not apply to the workers of small employers that are offering group health benefits with an employer contribution through an exchange.



Division of Health Care Finance and Policy  
Two Boylston Street  
Boston, Massachusetts 02116  
Phone: (617) 988-3100  
Fax: (617) 727-7662  
Website: [www.mass.gov/dhcfp](http://www.mass.gov/dhcfp)

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